



Ex-gratia payment made voluntarily by an employer is not taxable as 'profits in lieu of salary'

Background

Section 17(3) of the Income-tax Act, 1961 (the Act) brings certain payments such as profits in lieu of salary within the ambit of 'income from salaries'. Such payments include compensation due or received from an employer or a former employer at or in connection with the termination of employment or modification of the terms and conditions relating thereto and payment due or received under a keyman insurance policy.

The Gujarat High Court in the case of Arunbhai R. Naik¹ (the taxpayer) held that a voluntary payment made by the employer without there being an obligation on the part of the employer to pay any further amount, would not amount to compensation in terms of Section 17(3) of the Act.

Facts of the case

- The taxpayer was an employee of Gujarat State Fertilizer Company Ltd. (the employer). The taxpayer's services were terminated by the employer in 1984 under Rule 44 of the Company's Service Rules by payment of three months' basic pay and dearness allowance in lieu of a three months' notice.
- Aggrieved by the termination of services, the taxpayer filed a writ petition. However, the letters patent appeal filed by the employer was allowed by a Division Bench of the High Court of Gujarat and the termination of services attained finality. The Division Bench of the High Court of Gujarat had considered the termination as 'deemed retirement' and mentioned that the taxpayer was eligible for retirement benefits like gratuity/pension/post-retirement medical benefits scheme as per their eligibility
- During the pendency of the letters patent appeal, the taxpayer and the employer arrived at a settlement under which the taxpayer agreed not to litigate the matter any further. The said settlement provided the manner of computation of ex-gratia payment to the taxpayer and their eligibility for retirement benefits. Ex-gratia payment computed as per the terms of the settlement was made by the employer
- The taxpayer had filed his return of income claiming a refund of taxes paid. He had stated in the return of income the payment made by the employer under the settlement was a capital receipt as neither the terms of employment nor the service rules of the employer provided for such a payment. The return of income was processed, and the refund was granted. However, the case was taken up for scrutiny.

¹ Arunbhai R. Naik v. Income-tax Officer [2015] 64 taxmann.com 216 (Guj)

- The taxpayer placed reliance on the judicial precedents² in support of his submission. The Assessing Officer (AO) rejected the claim of the taxpayer that the ex-gratia compensation was a capital receipt, and the amount was added to total income.
- On appeal by the taxpayer, the Commissioner of Income-tax (Appeals) [CIT(A)] held that the amount of compensation was paid de hors any contract of employment and voluntarily as compensation for premature termination of employment, and hence was not taxable. The CIT(A) based his decision on the judicial precedents referred by the taxpayer, where it was held that a similar receipt was not taxable as salary.
- The Revenue went on to appeal before the Income-tax Appellate Tribunal (the Tribunal).
- According to the Tribunal, the payment was not in the nature of an ex-gratia payment or without there being an obligation on the part of the employer, as claimed by the taxpayer. The Tribunal was of the opinion that the payment was taxable within the meaning of Section 17(3) of the Act, which provides for the inclusion of compensation received from an employer or a former employer at or in connection with termination of employment.
- The Calcutta High Court, in the case of Ajit Kumar Bose³, was of the view that the payment in its true nature and character was ex-gratia, that is to say, totally voluntary and was not compensation which implies some sort of an obligation to pay. Accordingly, it was held that it cannot be said that the amount in question was 'profits in lieu of salary'. In the case of Jamini Mohan Kar⁴, the Calcutta High Court followed its earlier decision as in the case of Ajit Kumar Bose.
- In the case of Deepak Verma⁵, the Delhi High Court held that the word 'compensation' is not defined in the Act. Therefore, one has to take into consideration the ordinary connotation of this expression in common parlance. If the employee has no right to receive such a payment, it cannot be treated as 'compensation'. Hence, if the payment was made ex-gratia or voluntary by an employer and not conditioned by any legal duty or legal obligation, whether due to a sympathetic reason or otherwise, such a payment is not to be treated as 'profits in lieu of salary'.
- The High Court was in agreement with the views adopted in the judicial precedents. The question that arose was whether the payment was a voluntary payment given by the employer or was it in the nature of compensation.

High Court's ruling

- A reference was made to Section 2(24) of the Act wherein income is defined to include the value of any perquisite or profit in lieu of salary. If any amount falls within the ambit of the expression 'profits in lieu of salary', it has to be treated as salary and would be chargeable as 'income from salaries' under Section 15 of the Act.
- The High Court noted that the taxpayer was discharged from service by the employer and was paid three month's basic pay and dearness allowance as per the service rules of the employer. The taxpayer's writ petition challenging the discharge was not successful. The employer's letters patent appeal was allowed by a Division Bench of the Gujarat High Court, which recorded the settlement between the employer and the taxpayer, pursuant to which the amount in question was paid by the employer.

² CIT v. Jamini Mohan Kar [1989] 176 ITR 127 (Cal) and CIT v. Ajit Kumar Bose [1987] 165 ITR 90 (Cal)

³ CIT v. Ajit Kumar Bose [1987] 165 ITR 90 (Cal)

⁴ CIT v. Jamini Mohan Kar [1989] 176 ITR 127 (Cal)

⁵ CIT v. Deepak Verma [2011] 339 ITR 475 (Del)

- The High Court observed that the taxpayer's services were terminated in terms of the service rules of the employer and the amount in question was paid only in terms of the settlement, without there being an obligation on the part of the employer to pay any further amount to the taxpayer in terms of the service rules and that the employer, voluntarily at its discretion, agreed to pay the amount with a view to bring an end to the litigation.
- The Revenue's contention that the manner of computation of the amount paid under the settlement, reveals the same in the nature of terminal benefits on account of bringing an end to the services of the taxpayer. The Court opined that the manner of computation of the amount payable in terms of the settlement would not change the character of the payment, in as much as, the same being voluntary in nature and without any obligation on the part of the employer would not amount to compensation in terms of Section 17(3)(i) of the Act.
- The High Court held that there was no obligation cast upon the employer to make such a payment, and therefore, the amount in question would not fall within the ambit of the expression 'profits in lieu of salary' as contemplated under Section 17(3)(i) of the Act.
- The order passed by the Tribunal was quashed and the order passed by the CIT(A), deleting the addition made by the AO, was restored.

Our comments

The decision may be pertinent in cases where an employee is paid an ex-gratia amount over and above the termination benefit, as provided in the employment contract or other terms governing employment.



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